Tax Simplification:
Can We Get There from Here?

a presentation by

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Introduction

There is no magic formula that will allow governments to painlessly manage change, particularly during a time of economic stress. The delivery of state services is dependent on only two factors - the quantity and quality of services demanded by a state's citizenry, and that citizenry's willingness and ability to pay for those services. This paper does not address the level of spending that is appropriate; even though that is the single most important factor that impacts tax policy. Neither does it address every important issue that is currently part of the public discourse about state and local taxation. It seeks only to summarize some of the ways in which states raise revenues and suggest meaningful criteria for evaluating tax systems.

Principles of a "Good" Tax System

- Taxes should be adequate to provide an appropriate level of those goods and services best provided by the public sector, such as education, public safety and transportation.

- Taxes should do the least harm to the private economy. Tax bases should be as broad as possible so that tax rates can be as low as possible.

- Taxes should not only be fair and equitable towards individuals and businesses similarly situated, but they also must be perceived as fair by taxpayers. Individuals with the same income level should bear the same or similar tax burden. Businesses engaged in similar commercial activities should be subject to the same level of taxation.

- Taxes should not be costly for government to administer and should be easily understood by taxpayers so as to maximize taxpayer understanding and minimize taxpayer compliance costs.

- Taxes should be evaluated on the basis of the impact of all taxes levied on taxpayers, not just a single tax or tax rate.

- Deviations from sound tax policy in pursuit of economic development, social or other goals should be well-reasoned and implemented only when established tax policies are not significantly undermined and the results of such deviations can subsequently be evaluated.

Reform is Constant (at least consideration of it is)

- Since 2000 almost 40 states have conducted tax studies to guide change.

- "Reform" seems to include large-scale changes designed to further principles of adequacy, economic neutrality, equity, simplicity; revenue neutrality.

- Reform is harder to achieve than revision. Commissions usually recommend reforms; Legislatures usually enact revisions.

- Reform often creates winners and losers. Losers yell louder and longer.

State Taxes

States and local governments obviously have a need for monies to pay for the services that they provide to the people and institutions of their jurisdiction. The most common broad traditional bases to which tax is imposed are sales, income and property. In addition, there are specialty taxes on such items as tobacco, motor fuel, insurance and others. A list of the taxes traditionally collected by the states appears below.

Alcoholic beverages taxes
Amusements taxes
Compensating (Use) taxes
Corporation licenses
Corporation net income taxes
Death and gift taxes
Documentary taxes
Drivers' licenses
Stock Transfer taxes
Gross Receipts taxes
Hunting and fishing licenses
Individual income taxes
Insurance premiums taxes
Motor fuels taxes
Motor vehicle licenses
Occupation & business licenses
Pari-mutuels taxes
Property taxes
Public utilities taxes
Public utility franchise
Sales taxes
Severance taxes
Tobacco products taxes

Sales Taxes

Sales taxes began as simple applications of a tax rate to the retail price of sales of tangible personal property. Sales taxes are often deemed "fair" taxes in surveys of ordinary taxpayers, perhaps because they are thought of as pennies on the dollar. "Pyramiding", i.e., the application of tax to prior tax amounts in successive commercial transactions is one problem often cited with the sales tax. Taxing more services can actually exacerbate the problem of pyramiding of the tax. The other issue frequently cited with regard to the sales tax is the inequity created when the sales tax is applied to "necessities" which account for a greater percentage of income of low-income people. This problem has been reduced in recent years as states have removed the tax from sales of food and other essential items.

In recent years the focus of most of the efforts at expansion of the sales tax base has been on services as that sector of the economy has grown. The Federation of Tax Administrators periodically conducts a survey of the taxation of services. FTA first conducted a survey of service taxation in 1990. The survey is updated periodically.

The survey found that most states tax services to some degree. Utility services are taxed in most all states and admissions and repair services are taxed in many states. On the other hand, few states tax personal and business services. Professional services, such as doctors and lawyers, are taxed in only a handful of states.

Only Hawaii and New Mexico have broad-based sales taxes that include most all the services tracked by the survey. Delaware and Washington tax a large number of services, mainly through their low-rate business gross receipts taxes. South Dakota and West Virginia are the only other states to tax more than 100 services.

Several other states apply tax to a significant number of selected services. These include Arkansas, Connecticut, District of Columbia, Iowa, Kansas, Mississippi, Nebraska, New Jersey, Texas, and Wisconsin. These states widely tax utilities, admissions/amusements, and labor and repair services, but leave professional services largely untaxed. Of these states, Connecticut, District of Columbia and Texas tax more computer service than is the norm for most states. Also, Connecticut taxes more business services while Iowa taxes more personal and business services than others in this group.

The other big issue in the state sales and use tax area is the policy–litigation–legislation matter of the states' ability to require collection of use taxes by sellers that do not have a physical presence in the taxing jurisdiction (nexus). This issue has existed for decades as a result of two opinions of the United States Supreme Court. Essentially, the rule is that a taxing jurisdiction may not require a seller of taxable goods or services to collect a sales or use tax unless the seller has a physical presence in the taxing jurisdiction.

Income Taxes

Individual income taxes are largely understood because so many of us deal with them. Corporate income is a very specialized tax that is basically a tax on corporate profits. A company must determine whether it has nexus in a given state—that is, the company must determine whether it engages in a sufficient level of activity in the state to be subject to tax. The amount of in-state activity in which a company must engage before achieving nexus with a state for corporate income tax purposes is defined by a federal law known as Public Law 86-272, which asserts that a state cannot apply its corporate income tax to companies whose only connection to the state is the solicitation of orders from, or the shipment of goods to, the residents of the state. In most states businesses have to determine whether the income is "business" or "non-business" income, which will determine whether income is apportioned or allocated based on how it is earned. Apportionment is a complex exercise that gives rise to many issues and much litigation. Achieving fairness and simplification in this area is a daunting challenge.

Taxes and Economic Development

Some economists assert that economic incentives do not really work, i.e., businesses make decisions for reasons other than either tax policy or direct tax incentives. Many academicians suggest that they be eliminated. Although I do not have personal knowledge, it has been reported that Jim Edgar, several years ago when he was Governor of Illinois, suggested that states try to curtail or eliminate incentives. No state actually did that. It is alleged that Governor Edgar's colleagues did suggest to him that Illinois "go first." The point is that states are in a competitive marketplace. States are competing for economic prizes and, in that arena, you do have to pay to play. The only real question is price. I believe that good tax policy is good economic development policy. The primary considerations for business decisions are generally thought to be labor, capital, transportation, infrastructure and the quality of life for management and workers. But, in the matrix of decision-making, could taxes become the pivot point of the decision? The answer is yes. Tax policy should be considered as a very important part of overall economic development policy

Taxation and Public Trust

Americans have come to believe two totally contradictory principles at the same time – that we can have both low taxes and robust public services. The theme seems to be that, "I want those services, but that other guy should pay for it, not me." Senator Russell Long of Louisiana famously defined tax reform as: "Tax reform means 'don't tax you, don't tax me, tax that fellow behind the tree.'" If we recognize that we are a community of interests that suggests compromise and collective benefit and burden, then the debate can be meaningful and purposeful. That imperative presents a compelling, politically credible reason to think about comprehensive fundamental tax reform.

Summary

There are usually two components in a tax and spend discussion, cyclical and structural. An economic slow-down causes revenues to decline and expenditures to increase and growth and/or turnaround will cure the problem. The structural problem is caused by spending programs that are inflexible and require systemic solutions.

Raising revenue and spending are the two sides of the same coin. Less spending means less tax that must be collected. It is not the purpose of this paper to suggest a level of taxation that is appropriate or even the best methods of raising revenue. One suggestion I would make is that it is always appropriate to do a "reality check" on decisions of policy makers. The decision is ultimately one that is difficult for policy makers to make, choosing winners and losers from among the constituencies who elect them. Supreme Court Associate Justice Oliver Wendell Holmes said, "Taxes are the price we pay for a civilized society." We should always remember that the greater good is the goal and reason, honesty, selflessness and trust are the paths that must be taken to achieve it.

Potentially useful websites:
http://www.ncsl.org/research/fiscal-policy/state-tax-study-commissions.aspx
http://www.ncsl.org/research/fiscal-policy/2013-webinar-federal-tax-reform-and-states.aspx
http://www.ncsl.org/research/fiscal-policy/2014-tax-change-proposals.aspx
http://www.taxadmin.org/fta/rate/default.html
http://taxfoundation.org/article/annual-state-local-tax-burden-ranking-fy-2011
http://taxfoundation.org/top-10-state-tax-trends-recession-and-recovery-2008-2012
http://taxfoundation.org/article/tax-foundation-state-local-tax-burden-estimates-overview-methodology

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About the Author: Jim Eads is a Principal specializing in State Tax Issue Resolution and Strategy at Ryan, a tax consulting firm with the largest transaction tax practice in North America and offices worldwide. From 2008 until 2010 he served as the Executive Director of the Federation of Tax Administrators where he worked with and represented the tax agencies of the 50 states, New York City and the District of Columbia.

His career includes over thirty-nine years in state tax work. He has held positions with AT&T Corp., Sears, Roebuck & Co., Ernst & Young, the New Mexico Tax Research Institute, the Internal Revenue Service, and the Arkansas Department of Finance and Administration. He has served on the State Tax Advisory Board of CCH, the Advisory Board of the Georgetown Institute of State & Local Tax, the BNA Tax Management State Tax Advisory Board and as an Advisory Member of the Board of Directors of the National Tax Association (NTA) and is also a past President of NTA. He is a former Chairman of the Electronic Commerce Task Force of the Council on State Taxation.

He taught state tax law as an adjunct professor at the School of Law of the University of New Mexico and is the author of a chapter on federal preemption of state revenue authority in the Oxford University Handbook on State and Local Finance published by Oxford University Press

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He resides in Austin, Texas but works in all states and the District of Columbia.